



**U.S. Department of the Interior
Office of Inspector General**

SPECIAL REPORT

**EXTERNAL QUALITY CONTROL REVIEW
OF THE AUDIT DIVISIONS,
MINERALS MANAGEMENT SERVICE**

**REPORT NO. 98-I-398
APRIL 1998**



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

SPECIAL REPORT

Memorandum

APR - 2 1998

To: Associate Director for Royalty Management,
Minerals Management Service

From: Robert J. Williams *Robert J. Williams*
Acting Inspector General

Subject: Special Report on the External Quality Control Review of the Audit Divisions,
Minerals Management Service (No. 98-I-398)

INTRODUCTION

This report presents the results of our external quality control review of the Audit Divisions of the Minerals Management Service. The Service requested this review to be in compliance with the "Government Auditing Standards," issued by the Comptroller General of the United States, which requires organizations conducting audits in accordance with these standards to undergo an external quality control review every 3 years.

This is the second report we are issuing on the Service's Audit Divisions. The first report contained the results of our audit of the Minerals Management Service's work regarding alleged underpricing of California crude oil. Because the Service's work on the underpricing of California crude oil was conducted under different controls, including methodology and performance procedures, the conclusions in that report do not relate to the Service's audit work covered by our external quality control review.

BACKGROUND

The Minerals Management Service is responsible for managing royalties relating to minerals produced from most Federal and Indian lands. Specifically, the Service collects about \$4.4 billion annually in rents, royalties, and other payments; maintains necessary accounting records; prepares royalty liability determinations; and conducts audits of royalty payments to ensure that royalties received represent fair and equitable value. To help accomplish its responsibilities, the Service has established financial and production accounting verification systems, compliance and enforcement programs, and an overall audit strategy.

The Audit Divisions are responsible for conducting audits of royalty payors to ensure that the correct amount of royalties is reported and received. The Divisions are guided by a 5-year audit strategy and an audit plan that is updated annually. The strategy provides for a wide range of audits that cover specific companies and special issues or projects such as processing allowances pertaining to gas plants, production allocations specified by unit agreements, contract settlements, and royalty payments made from individual Indian leases. These audits are performed by residency teams permanently stationed at the 11 largest royalty payor companies (see Appendix 1) and by mobile teams that visit smaller companies selected for review.

The Audit Divisions consist of a headquarters office in Washington, D.C., and compliance divisions located in Lakewood, Colorado, and Dallas and Houston, Texas. The Dallas Compliance Division also has compliance offices located in Oklahoma City and Tulsa, Oklahoma. The Audit Divisions have a total of approximately 190 auditors.

OBJECTIVE AND SCOPE

The objective of our review was to provide reasonable assurance that audit work of the Audit Divisions was performed in accordance with the "Government Auditing Standards" and with policies and procedures contained in the Service's Audit Procedures Manual.¹ To accomplish the objective, we judgmentally selected for review 19 audits, consisting of 6 audits each from the Lakewood and the Houston Compliance Divisions and 7 audits from the Dallas Compliance Division. The sample for the Dallas Compliance Division included two audits from the Oklahoma City Compliance Office and one audit from the Tulsa Compliance Office. Our sample was taken from summary lists prepared by the Service and reportedly represented all audits performed by the Service for the October 1, 1995, through May 1, 1997 period (see Appendix 2). Our review did not include any other work performed by the Audit Divisions during this time period and did not evaluate the economy or efficiency of the Audit Divisions operations. In addition, we did not evaluate the adequacy of the Audit Divisions overall audit strategy. The audits reviewed represented a cross section of audit activities, audit teams, and supervisory officials. We examined audit reports and other audit report products such as issue letters (formal notifications of royalty underpayments), orders to perform (demands for companies to recompute additional royalties owed), orders to pay additional royalties, and audit closure letters; the supporting working paper files; and employee training records.

The review was performed at the Service's Royalty Management Program offices in Lakewood and at Compliance Division offices in Lakewood, Dallas, and Houston. We also visited the Service's audit residency offices located at Chevron Oil Company in Concord, California, and Texaco, Incorporated, in Houston. Our review was made in accordance with

¹The Audit Procedures Manual, dated December 1, 1989, was applicable to the audits that we examined for this external quality control review.

the discussion draft titled "Guide for Conducting External Quality Control Reviews of the Audit Operations of Offices of Inspector General,"² dated December 1996, and issued by the President's Council on Integrity and Efficiency.³ This draft discussion guide provides the standards and detailed guidance for conducting external quality control reviews required by the quality control standard in the "Government Auditing Standards."

PRIOR REVIEW

The last external quality control review of the Audit Divisions was conducted by the Office of Inspector General in February and March 1991. The resultant May 1991 report concluded that, with only minor weaknesses in the areas of individual job planning, legal and regulatory requirements, internal controls, audit evidence, supervision, and reporting, the Royalty Compliance Division (which became the Audit Divisions in a 1992 reorganization) was in compliance with the "Government Auditing Standards." The report contained no recommendations.

During our current review, we noted that the Service was not timely with its request for an external quality control review, as the prior review was completed about 5 years before the Service requested the current review. Accordingly, we believe that the Service should ensure that it complies with the requirement (Paragraph 3.33) of the "Government Auditing Standards" by undergoing an external quality control review at least once every 3 years.

DISCUSSION

Based on our review of the 19 audits, we concluded that the audit work performed by the Audit Divisions was generally in compliance with the "Government Auditing Standards" and the Service's Audit Procedures Manual. Specifically, the audits were conducted in a professional manner; audit conclusions were adequately supported by the working papers; and, with few exceptions, auditors were current in their continuing education requirements. Although we found minor weaknesses in the areas of compliance with laws and regulations, internal quality controls, audit supervision, timeliness of report products, and working paper quality, we also found that the validity of each audit finding and conclusion was not adversely affected, as described in the following paragraphs.

²During the entrance conference for the external quality control review, officials representing the Minerals Management Service and the Office of Inspector General agreed that the review would be conducted using the draft discussion guide.

³The President's Council on Integrity and Efficiency was established by Executive Order in March 1981 to provide leadership in Governmentwide efforts to reduce fraud, waste, and mismanagement in Federal programs.

Compliance With Laws and Regulations

The working paper files for the 19 audits that we reviewed did not indicate that the Service had conducted a risk assessment to aid in detecting significant illegal acts. The "Government Auditing Standards" (Paragraph 6.28) states that a risk assessment should be performed so that specific audit procedures can be designed to provide reasonable assurance of detecting significant illegal acts. Because the royalty payment process for Federal and Indian mineral leases is complex and frequently involves large monetary amounts, we believe that auditors should be more cognizant of their responsibility to detect fraud and other illegal acts.

Internal Quality Controls

The Service established an internal quality control system, as required by the "Government Auditing Standards" (Paragraph 3.31), which we believe provided reasonable assurance that the Service's Audit Procedures Manual was complied with and that audits were generally conducted in accordance with the "Government Auditing Standards." However, we also concluded that the system could be strengthened as follows:

- **Internal Quality Control Review Program.** We found that the internal quality control review program which the Service initiated in 1996 generally operated efficiently and effectively. The program ensured that individual audit offices were evaluated on a regular and uniform basis, the internal reviews were completed timely, weaknesses identified in the internal review reports were balanced with noteworthy accomplishments of the offices, and appropriate officials were briefed on the results of the internal reviews. However, as currently designed, the internal quality control review program does not include tests for:

-- Compliance with the general standards covering staff qualifications, independence, and due professional care. The "Government Auditing Standards" (Paragraph 3.32) requires that an internal quality control review program be designed to evaluate compliance with all applicable standards. Accordingly, the scope of the program should be expanded to include testing of the general standards.

-- Determining whether a risk assessment for compliance with laws and regulations was performed, as required by the fieldwork standards of the "Government Auditing Standards" (Paragraph 6.28). Accordingly, the program should include this step to verify that the auditors assessed the risks that significant illegal acts could occur and, as necessary, that the auditors designed and performed procedures to provide reasonable assurance of detecting significant illegal acts, as discussed in the prior section ("Compliance With Laws and Regulations").

- **Other Quality Control Matters.** During our review, two issues that related to ensuring the accuracy of report products were disclosed as follows:

-- Five of the 19 audits reviewed did not have an independent verification of computations. Although neither the "Government Auditing Standards" nor the Audit Procedures Manual specifically requires an independent verification, this procedure helps to satisfy the "Government Auditing Standards" requirement (Paragraph 7.50) that findings should be presented accurately in reports.

-- The Audit Divisions were considering a significant policy change concerning the referencing process for final audit report products. Specifically, report referencing may become an optional rather than a mandatory procedure. In our opinion, the referencing process is an important tool that helps ensure the accuracy and overall quality of the report product. Accordingly, we strongly encourage the Audit Divisions to reconsider this policy change and to continue the existing requirements for report referencing.

Audit Supervision

We found that all audits were supervised but that the supervision was not always accomplished in a timely manner. The "Government Auditing Standards" (Paragraph 6.64) states that working papers should contain evidence of supervisory review of the work performed. Further, the Audit Procedures Manual (Section 7.6) requires supervisors to review the working papers "after segments⁴ of the work are completed." However, for 12 of the 19 audits, the supervisory review of many working papers ranged from 3 to more than 12 months after the documents had been prepared. Additionally, for 5 of the 12 audits, the report product was issued, even though working papers had no indication that a supervisory review had been performed. The "Government Auditing Standards" (Paragraphs 6.22 and 6.23) requires staff to be properly supervised. Timely supervision of the working papers will reduce the risk that undetected errors or unsound conclusions could be included in the Service's report products.

Timeliness of Report Products

We found that report products for 2 of the 19 audits could have been issued more timely. Specifically, two orders to pay additional royalties relating to an audit of an oil company were issued at least 6 months after the draft orders had been prepared, and an order to pay additional royalties relating to the audit of a second oil company was issued about 2 years after the underpayments were identified. The "Government Auditing Standards" (Paragraph 7.6) states that reports should be issued "to make the information available for timely use."

Working Paper Quality

The supporting audit working papers were generally prepared in accordance with the Audit Procedures Manual (Section 7). However, some of the working papers and files for 13 of the 19 audits did not have one or more of the following items: the required source, purpose, and conclusion; a table of contents; indexing (specifically, page numbers); adequate cross-indexing

⁴A segment is a series of audit steps focusing on a specific area of the audit.

to the supporting working papers; the preparer's name; and a heading describing the working paper contents. Also, some records were not permanently attached to the files. In our opinion, these deficiencies did not adversely impact the overall quality of the audit working papers. However, we believe that the quality of working papers could be improved with more timely supervisory reviews.

A response to this report is not required. However, if you have any questions regarding this report, please call Mr. Alan Klein, Director of Performance Audits, at (303) 236-9243.

We appreciate the assistance of Minerals Management Service officials in the conduct of our review.

**AUDIT RESIDENCY OFFICES
MINERALS MANAGEMENT SERVICE**

<u>Office Location</u>	<u>Company Name</u>
Dallas Compliance Division	
Dallas, Texas	Mobil
Dallas, Texas	ARCO
Ponca City, Oklahoma	Conoco
Tulsa, Oklahoma	Amoco
Bartlesville, Oklahoma	Phillips
Houston Compliance Division	
Houston, Texas	Exxon
Houston, Texas	Shell
Houston, Texas	Texaco
Houston, Texas	Unocal
Lakewood Compliance Division	
Concord, California	Chevron
Findlay, Ohio	Marathon

AUDIT SAMPLE SELECTION

<u>Office Location</u>	<u>Company Name</u>	<u>Case Number</u>	<u>Type of Audit</u>
Dallas Compliance Division			
Dallas	ARCO	9340001	Residency*
Dallas	Thriftway	5-40222	Company**
Dallas	Sunwest Petroleum	9540229	Special issue***
Dallas	Meridian	9240205	Special issue
Oklahoma City	Jenex Petroleum	9665511	Special issue
Oklahoma City	Merrico	6-65507.000	Company
	(TriPower Resources)	through .006	
Tulsa	Yates	5-40215.005, .011, and .014	Special issues
Houston Compliance Division			
Houston	Badger Oil	9520008	Company and special issue
Houston	CNG Producing	9320081	Special issue
Houston	Enron Oil & Gas	8820055	Special issue
Houston	UMC Petroleum	9420030	Special issue
Houston	Shell	2-22708.017 and .022	Residency
Houston	Texaco	3-20069	Residency

*Residency audits are comprehensive royalty reviews of the 11 largest royalty payor companies that are conducted by audit staff stationed at the companies (see Appendix 1).

**Company audits are comprehensive royalty reviews of the next largest 115 royalty payors, as well as randomly selected smaller companies, that are conducted by mobile audit teams.

***Special issues cover a variety of royalty verification activities, including audits of gas processing plants, the companies' royalty accounting systems, lease inspections performed by the Bureau of Land Management, individual leases, contract settlements, and royalty settlements. These audits are conducted by mobile audit teams.

<u>Office Location</u>	<u>Company Name</u>	<u>Case Number</u>	<u>Type of Audit</u>
Lakewood Compliance Division			
Lakewood	Chevron	3-30001.033	Residency
		6-30503.000	
		6-30501.022	
		5-30238.000	
Lakewood	Axem Resources	3-30094	Special issue
Lakewood	Energy Minerals	4-30057	Special issue
Lakewood	Questar	3-30004	Company
Lakewood	Mayo Foundation	5-30212	Company
Lakewood	Pan Canadian Petroleum	5-30206	Special issue

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North Pacific Region
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